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Issues Related To Foreign Oil Supply Diversification

Senator Max Baucus and Congressman Donald Pease raised a series of questions about diversification of U.S. foreign oil supply sources. This report answers their questions on

--the advantages of supply diversification,

--U.S. support for the World Bank program to accelerate petroleum production in developing countries, and

--whether U.S. oil companies were involved in developing the U.S. position on the World Bank program for accelerating petroleum production in developing countries.

Oil importing

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The Honorable Max Baucus
United States Senate

The Honorable Donald J. Pease
House of Representatives

This report is in response to the questions raised in your joint letter of December 14, 1978, concerning oil source diversification policy and the U.S. position on the World Bank program to accelerate petroleum production in developing countries.

We plan no further distribution of this report until 30 days from the date on the cover. At that time, we will send copies to interested parties and make copies available to others upon request.

J. K. Fasick

J. K. Fasick
Director

WHAT IS TO BE GAINED FOR THE U.S. THROUGH THE PURSUIT OF POLICIES WHICH WILL LEAD TO THE DIVERSIFICATION OF OUR FOREIGN OIL SUPPLIES?

The principal benefits to the United States of foreign oil supply diversification are

--increased supply security and

--increased independence for foreign policy formulation and execution.

These benefits were recognized in the National Energy Plan II which had as an immediate objective the reduction of dependence on foreign oil and vulnerability to supply interruptions. Among other actions, the Plan called for worldwide diversification of sources of oil production.

Significant supplier diversification will require development of new oil and gas sources in addition to those in the current producing countries. Recognizing this, a number of experts have studied the possibility of finding other sources of oil and gas. Some conclude that there is a high probability of discovering additional supplies of significant size--mostly in less developed countries (LDCs), many of which are underexplored or entail high development costs that have made development uneconomic at previous energy prices. In addition to making supply source diversification possible, successful development of new sources could offer the United States the following benefits:

--Improve the availability of secure hydrocarbon resources during the period for conversion to inexhaustible resources.

--World economic and social stability could be improved since the economic development of those LDCs in which oil and/or gas is found would be greatly helped by reducing or removing their dependence upon the Organization of Petroleum Exporting Countries (OPEC) and its crippling prices.

--A sufficient increase in the world's petroleum supply and its dispersion throughout different competing countries and political groups offers the potential for reducing the ability of OPEC to sustain artificially high prices and production restraints for political motivations.

--Development of new sources in LDCs also offers the possibility of helping our balance-of-payments if oil imports were to be tied to U.S. exports.

On the other hand, some experts maintain that new oil finds may not yield significant export capacity, and, if world supply threatens to exceed world demand, OPEC will simply restrain production to keep prices up. Some also argue that actions which enable more LDCs to become self-sufficient in oil would also better enable OPEC to harm the United States through price increases and production cutbacks without also hurting as many LDCs.

ADVANTAGES OF DIVERSIFICATION

Supply security

The major advantage to diversifying our foreign oil supply sources is the increased supply security which could be achieved by shifting a significant portion of our imported oil dependency to non-OPEC and, more specifically, non-Arab nations. The security of our Middle East oil supplies is vulnerable to terrorist, military, and political disruptions.

The long tanker routes from the Persian Gulf through the Straits of Hormuz and across the Indian and Atlantic Oceans could be cut by air or sea forces during a military conflict. The oil fields and terminal facilities are vulnerable to terrorist actions.

Furthermore, our continuing heavy reliance upon the Middle East Arab nations for most of our oil imports makes us vulnerable to damaging price increases and supply restrictions by the political bloc represented by the Arab nations.

A third aspect of supply security is that of assuring future supply. A recent report by the staff of the Congressional Budget Office 1/ noted the danger of a squeeze out from future world oil markets if the United States continues to do nothing. The report stated:

"As the U.S. Government debates the need for its involvement, the Governments of Japan and most Western European countries already appear

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1/A Strategy for Oil Proliferation: Expediting Petroleum Exploration and Production in Non-OPEC Developing Countries, Roach, The Congressional Budget Office, February 23, 1979.

> to have begun their own strategies for oil proliferation. Add to these unilateral policies the recently approved World Bank program, plus potential investments from the United Nations, the Asian Development Bank, and the OPEC Funds, and the chances for adequate oil exploration without U.S. participation in developing countries seem quite good.
>
> "Unfortunately, although this flood of investment funds may mark the end of a problem for the non-OPEC nations, it may herald the beginning of a problem for the United States. If unilateral policies were actively pursued, the United States could find itself in a world in which all oil production is marketed according to government-to-government contracts complete with barter deals. Furthermore, guaranteed loans from the World Bank and other sources can only damage further the competitive position of the international oil companies--the suppliers on which the United States depends. At present, there is no problem, but the topic warrants consideration, especially in light of the recent courting of Mexico by Japan, France, Britain, and Canada."

Political independence

Overreliance upon the Arab world for oil also places constraint upon U.S. foreign policy in the Middle East.

As long as the United States remains tied to the Arab world for the bulk of its oil imports, U.S. foreign policy will be influenced by that dependency. Given the fact that dependency remains and political differences exist between the United States and its Middle East oil suppliers, the temptation will remain for Arab supplier countries to use oil prices and supply restraint as a weapon against the United States with resultant economic damage to both the U.S. and world economies.

GAO issued a report, "More Attention Should be Paid to Making the U.S. Less Vulnerable to Foreign Oil Price and Supply Decisions," (EMD-78-24) on January 3, 1978, which addressed these concerns.

Oil proliferation

During hearings before the Subcommittee on Energy of the Joint Economic Committee in March 1978, a State Department official said, concerning the oil and gas potential of non-OPEC developing countries, that

> "* * * any increase in supply, whether exported or used to replace imports, will help reduce the pressure of demand on oil supply in the 1980's. To the extent that they are able to reduce their dependence on imported oil and gas, developing countries will be better insulated from the economic consequence of high oil prices. Also, they will become less reliant on international lending agencies, more able to sustain stable economic growth, and perhaps less inclined to turn prematurely to nuclear power as a source of new energy supply."

Discovery of additional sources of oil and gas will extend the date when the world's known petroleum supply runs out. Although some experts feel that the undiscovered oil fields will be small they do not all agree that all future finds will be too small for export potential. In this regard the argument is made that if more world market suppliers can be developed, the additional supplies might reduce the upward pressure on prices, or at least make it more difficult for OPEC to raise prices in the future. Others do not agree that this is a reasonable expectation over the near term because of the large quantity of oil controlled by the Organization of Arab Petroleum Exporting Countries (OAPEC), and the fact that the major producer--Saudi Arabia--cannot absorb the tremendous amounts of revenue it is now generating and can therefore reduce its production a great deal without incurring financial hardship. They argue that OPEC oil prices today are not the result of a free market supply and demand exercise, but represent an arbitrary decision of a suppliers cartel with firm control of an essential commodity.

Furthermore, development of oil production in developing countries holds forth increased trade possibilities for U.S. exporters. Barter arrangements of U.S. commodities and/or technology in exchange for crude oil and gas might be arranged. This is a concept worth consideration, because the United States could benefit from barter arrangements not only from additional security of supply, but also because U.S. exports would help offset the increased cost of oil imports. West Germany and Japan import far more than half of their oil needs, yet neither of these countries suffers a balance-of-payments or trade deficit or weak currency--primarily due to strong export performance.

OBSTACLES TO DIVERSIFICATION

Some experts maintain that as world supply increases, OPEC will simply restrain production to keep prices up and extend its production life. Furthermore, the removal of other countries from OPEC's customer list might enable OPEC to more precisely target embargo and pricing warfare directly against the United States without worrying about injuring LDCs.

Other arguments against attempting to diversify our foreign oil sources concern the practical limits of such efforts. For example, some contend that

--the biggest and best oil fields were found first (those yet to be found are likely to be small and difficult to develop),

--lead time from discovery to production is very great (production from new sources would take at least 5 to 10 years),

--some foreign government policies inhibit exploration and production, and

--the funds and technology required to bring any finds out of the harsh environments of most of the unexplored regions will be very great.

WHY HAS THE ADMINISTRATION BEEN SO SLOW TO SUPPORT A WORLD BANK PLAN DESIGNED TO ESTABLISH A REVOLVING FUND WHICH WOULD FINANCE OIL EXPLORATION IN NON-OPEC DEVELOPING COUNTRIES WHEN IT IS ESTIMATED THAT IT WOULD ONLY COST THE U.S. ABOUT $33 MILLION?

The genesis of the plan mentioned in the question apparently began at the Conference on International Economic Cooperation held May 30 to June 2, 1977, in Paris. France suggested the establishment of an internationally financed fund for oil and gas exploration in developing countries. During the following year World Bank staff discussed the idea with U.S. executive branch officials and with Canada.

Before 1973, the World Bank did not finance projects involving petroleum production, primarily because private capital was available for developmental projects, and commercial production in most developing countries was uneconomic at then prevailing international prices. After the dramatic increase in petroleum prices in 1973, however, the Bank began to review its lending policies for energy development.

In July 1977, acting upon a recommendation from the London Economic Summit Meeting, the Bank expanded its energy sector lending program to include projects for developing and producing fuel and nonfuel mineral resources, including petroleum. At that point, it did not finance exploration for oil or gas.

In June 1978, a World Bank official suggested to a high ranking U.S. official that the United States propose at the July 1978 Economic Summit Meeting in Bonn the establishment of a $500 million fund to be administered by the World Bank for oil and gas exploration in developing countries. The fund would consist of contributions by members of both the Organization for Economic Cooperation and Development (OECD) and OPEC. The suggested proposal stated that while firm commitments of funds could not be expected at the Summit Meeting, if the Summit members (the United States, United Kingdom, France, Canada, Germany, Italy and Japan) were to endorse the proposal, they should plan to jointly contribute not less than $300 million, with the rest coming from OPEC members and other OECD countries.

The suggested proposal stated that increasing production of oil and gas in developing countries is important in order to increase the world's supplies of energy resources and, even where the deposits are too small for export potential, to reduce the dependence of developing countries on imported energy. It pointed out that, while accelerating exploration is a precondition for future expansion of oil and gas production, exploration in LDCs has actually decreased. It stated that that exploratory drilling in LDCs had declined since the early 1970s by about 20 percent, while it has increased by over 30 percent in the United States.

The number of exploratory wells drilled in the developing countries of Latin America, Africa and Asia (excluding centrally planned economies) in 1976 was only 816 compared with 9,234 in the United States although the LDCs combined petroleum prospective area was four times larger and historically less explored. The suggested proposal stated that the inhibitions to increased drilling in these countries are several, but most important among them are (1) lack of interest of most large oil companies in small- or medium-sized prospects outside politically safe areas (i.e., the United States), (2) the inability of medium and small national and private oil companies to spread the risk adequately, and (3) uncertainty of foreign investors regarding the conditions of participation in follow-on development.

While the United States did not make this proposal at the Summit Meeting, Canada did and was strongly supported by France. The U.S. delegation did not support it for the following reasons:

--The evidence was not conclusive that lack of capital was the primary constraint on energy exploration in LDCs.

--U.S. officials did not think that high risk exploration was an appropriate use of public funds.

--Because the Congress was showing considerable reluctance to meet normal U.S. financial contributions to the World Bank, U.S. officials did not think it would be wise to imply that the United States was prepared to commit additional funds to the Bank--even for energy purposes.

Therefore, the final text of the communique from the members of the Bonn Economic Summit did not mention an oil exploration fund in referring to the need for further work in energy resource development. It stated:

"* * * We suggest that the World Bank explore ways in which its activities in this field can be made increasingly responsive to the needs of the developing countries, and to examine whether new approaches, particularly to financing hydrocarbon exploration, would be useful."

Following the Bonn Summit, the Bank went to work preparing a more detailed analysis of the exploration problem for discussion by its Board of Executive Directors in mid-October 1978. There was considerable consternation over the Bank's suggested exploration fund within the Departments of Energy, State, and the Treasury. Some U.S. officials were not convinced by the Bank's premise that insufficient private capital was the primary reason for the oil and gas exploration gap in LDCs. They also feared that the generation of public funds might merely displace private funds, rather than add to them, and if the displacement were not on a dollar-for-dollar basis the end result might even be that less rather than more capital would be available for exploration. Official funds--primarily on a grant basis--would be very attractive, and their availability might hold back any trend, for example, toward improved host government-company relations. LDC governments might also be reluctant to compromise on private contract terms if alternative financing were available, and donor countries would find it difficult to justify the appropriation of additional funds for the Bank when a good case could be made that private funds would otherwise have been available.

U.S. officials were also concerned that the availability of public funds to LDCs might encourage exploratory drilling where there was little hope of success. This could result in misallocation of scarce resources (capital and drilling equipment) from areas of high probability to areas of low probability, and delay discovery of new resources.

On the other hand, there was also some support for the Bank's plan within the Department of Energy. The supporters did not appear to disagree with the arguments raised by those opposing the plan. They seemed anxious to see some progress made toward developing alternative sources of imported oil and gas for the United States, and the Bank's plan, while perhaps not the best, was the only plan on the horizon. Nevertheless, attempts to resolve the conflict within the executive branch delayed its reaching a final position.

By October 1978, the Bank staff was concerned with the lack of support for the fund concept in the United States and some other countries, and delayed its proposal. When the formal proposal was made to the Board on November 30, 1978, the international fund concept had been dropped in favor of a program which was basically an extension of Bank lending policy to include oil and gas exploration projects. In addition to providing financial assistance for oil, gas, and coal production, the Bank's proposed program would include advice on national energy planning and assistance for pre-development activities as follows:

--Financing of experts to assist in national energy planning would be provided in technical assistance, engineering and production loans and credits and, if necessary, in the Bank's administrative budget.

--Technical assistance loans or credits to provide assistance in commissioning new geological surveys or in evaluating and updating data from earlier surveys would be made available.

--The Bank would be willing to help and advise LDC governments and foreign collaborators in concluding agreements for petroleum exploration and production, and to finance the eventual production facilities, providing the project met the usual criteria. The Bank would consider making loans or credits to member governments of oil-importing LDCs to cover their share of exploration costs undertaken in association with a foreign enterprise. In countries where foreign investors are unwilling to invest capital in petroleum exploration, the Bank would be prepared to consider lending to cover costs of exploration done by an exploration company under a service contract.

--Engineering loans and credits would also be available to finance appraisal drilling for fuel mineral projects.

This new approach was addressed to overcoming political and economic disincentives to private capital as the primary means of increasing oil and gas exploration in LDCs. By helping and advising LDCs and foreign companies in concluding exploration and production agreements, the Bank hoped to assure both the LDC and the oil company that the terms of exploration and production contracts were equitable to both parties. In this manner, the Bank hoped to reassure the LDC that it would not be exploited or treated unfairly by a multinational oil company and thus influence the country not to impose unrealistic or impossible demands. In the same vein, the Bank's presence as a buffer also could provide the private oil company a degree of protection against expropriation or unilateral changes in contract terms after oil was discovered.

This proposal was formally made to the Bank's Board of Executive Directors on November 30, 1978, and was approved on January 16, 1979. In addition to overcoming all the arguments against the separate fund concept, this program has the considerable advantage of being able to make funds and assistance to LDCs available immediately without going through the time-consuming international fundraising process. Objections were heard within the U.S. executive branch that (1) oil and gas exploration loans amounted to placing the Bank's public funds at too great a risk, and (2) doing so might jeopardize the Bank's credit standing in the private capital markets from which the Bank borrows much of its operating capital. However, these objections are largely overcome because the thrust of the Bank's program is to use its presence and influence to attract private capital with Bank financing and assistance acting primarily as a catalyst.

IS THERE ANY INDICATION THAT ANY ENERGY COMPANIES BASED OR OPERATING IN THE U.S. PARTICIPATED IN OR WERE CONSULTED BY U.S. GOVERNMENT OFFICIALS IN THE PROCESS OF CONSIDERING, EVALUATING OR DEVELOPING A POSITION WITH RESPECT TO THE U.S. MAKING A CONTRIBUTION TO THE WORLD BANK REVOLVING FUND?

Treasury Department officials told us that they did not solicit oil company views specifically on the World Bank proposal of November 30, 1978, or the revolving fund previously considered, but over the years had been in fairly constant dialogue with oil company officials concerning U.S. energy policy.

We asked officials of a number of the major oil companies if their company had been asked directly by members of the executive branch for its opinion of the Bank proposal. Their responses follow.

Gulf Oil Company

A Gulf spokesman said his firm has been involved in the evolution of the present Bank program for at least 3 to 4 years. Based upon its past experiences in less-developed countries, Gulf feels that participation by the World Bank or similar international institutions in risky projects, such as oil and mineral exploration, is a good idea to protect private capital from host governments unilaterally changing the rules after such projects begin to pay off.

The Gulf spokesman said that after seeing news reports on the World Bank's consideration to finance oil and gas development projects, he called the Bank and discussed the concept with Bank staff and suggested that Gulf would like to participate in a trial project. The Bank agreed and from this came an agreement with the Bank and the Government of Pakistan for oil development and production. Since then Gulf has worked out a similar agreement with Zaire and the Bank's International Finance Corporation for oil exploration and development.

He said that Gulf officials have had discussions with the Bank staff during development of the current program, as well as with officials of the Departments of State and the Treasury. He said that Gulf is in favor of the current program, and is not concerned with the downscaling of the program from a separate fund of $500 million to an extension of lending policy. He said a large fund is not necessary to start the program for the following reasons:

--Committing donors to contribute the additional funding for a large new fund would take a long time and delay the program.

--Exploration and development projects take a long time to negotiate and reach agreement and start work. During this time the resources of a separate dedicated fund would be idle.

--The World Bank doesn't actually need very much of its own funds to participate in a project. The necessary ingredient in a risky project is the Bank's presence and its influence rather than its money. The Bank's prestige usually attracts commercial venture capital to the project and the Bank then sells participation shares in its portion of the project financing to commercial banks.

Exxon Corporation

An Exxon official told us that his firm first became aware of the World Bank program for oil exploration in late 1977 or early 1978 when congressional hearings produced statements that very little oil exploration had taken place in LDCs. He said this is not true--Exxon has done considerable exploration in LDCs, and he is sure that other companies have also. Following this, he said, he saw an article in Platt's Oilgram describing the then-contemplated World Bank program. He visited the Bank and talked with the staff involved with the program to learn more about it.

He said that Exxon had some questions about the Bank program and questioned some of the data and assumptions it was based upon. Exxon then contacted the Departments of State, the Treasury, and Energy and asked them if they were interested in Exxon's questions and views on the Bank program. This resulted in a number of meetings and discussions with officials and staff of those agencies as well as the Central Intelligence Agency and the World Bank in which Exxon voiced its viewpoint and provided statistics and information. At the culmination of this round of talks, Exxon set forth its views and suggested caution in a letter to the Secretary of the Treasury.

Basically, Exxon does not think the Bank program is necessary and questions the use of public funds in such risky activities as oil exploration.

Standard Oil of Indiana

When asked if any agency of the U.S. Government had asked for his company's opinions or views of the World Bank's proposed oil exploration financing program, a company spokesman said that a U.S. Senator had pursued the question through one of his senior staff while working on legislation concerning the U.S. Overseas Private Investment Corporation (OPIC), but no one in the executive branch has ever asked for his company's views on the proposal.

However, he said the general concept of a publicly financed exploration fund and a third party intermediary between LDC governments and oil companies has been discussed within oil company and U.S. Government circles for a long time. He said he has been aware of it for at least 5 years and has often discussed the idea with World Bank staff and U.S. executive branch officials over a long time period and has personally made a point of monitoring the concept's general evolution.

He said his firm strongly favors a strengthened role for OPIC in oil and gas exploration, but is neutral on the World Bank plan. He said his company can see both potential benefits and potential problems with the Bank program, but it is too early to judge its effectiveness. Standard's position is to be open and fair and not prejudge the effectiveness of the Bank program until it has had a chance to prove itself. The spokesman said that Standard Oil of Indiana strongly disassociates itself from the position taken by Exxon in its letter to the Secretary of the Treasury. He said that his company is actively looking for an opportunity to work with the Bank on a project and test the new program.

Mobil Oil Company

A Mobil spokesman said that Mobil was not asked directly for its views on the Bank proposal, but the general idea the proposal is based upon has been around Washington for at least 4 years. He said he has discussed the general concept with the Treasury and State Department staff a number of times. He said what they were discussing then was not a specific World Bank role or program, but just the general merits of a third party intermediary role by an international organization or government in exploration or other high-risk agreements between oil companies and LDC governments.

During this past year, he recalled, World Bank staff contacted him directly and later visited Mobil headquarters in New York to specifically discuss the World Bank's potential role in stimulating oil exploration in LDCs. He said there is a tremendous contrast of viewpoints on the need for the World Bank proposal and the potential good or harm that it may do. He said that even within Mobil there are many who think it is a good idea and many who think it is not.

Shell Oil Company

A spokesman at Shell's headquarters in Houston, Texas, said that to the best of his knowledge Shell's opinion on the Bank proposal was not solicited by anyone in the executive branch. He said he had read of the proposal in the newspaper and made some inquiries at the State Department as to the nature of the proposal, but did not pursue it any further.

He said that U.S. Shell is independent of Royal Dutch Shell and has very few overseas operations. Consequently, it has not been concerned with the Bank program.

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